

No. 14,785

United States Court of Appeals
For the Ninth Circuit

WEYL-ZUCKERMAN & COMPANY,

Petitioner,

VS.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

OPENING BRIEF OF PETITIONER.

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OPENING BRIEF OF PETITIONER.

1. Statement of the case in compliance with Rule 18(2)(c).

The question to be decided is whether the conveyance of property by the petitioner was made without business purpose and was the initial step in a program the objective of which was to evade capital gain taxes.

McDonald Island is located in the delta region of the San Joaquin River. It comprises two tracts separated from each other by a slough. One is called Henning Tract and the other McDonald Tract.

The petitioner, Weyl-Zuckerman & Co., a corporation, sometimes hereinafter called Weyl—and its predecessor partnership had long been the owners and farmers of Henning Tract.

McDonald Island Farms, Ltd., a corporation,—sometimes hereinafter called McDonald, Ltd.—had for many years owned and operated McDonald Tract.

Until 1931 there was no connection between the two companies.

In 1931, in association with another company—Holly Sugar Corporation—Weyl acquired an interest in McDonald Island Farms, Ltd., and by a series of transactions during the year 1946 Weyl bought out Holly Sugar Corporation. One of the consequences was that Weyl became the owner of all of the capital stock of McDonald Island Farms, Ltd.

To finance the transaction a large loan was negotiated from the Bank of America. In this connection it was decided that the farming operations of the entire island should be consolidated. For various reasons the subsidiary—McDonald—was selected and on June 27, 1946, Weyl conveyed Henning Tract to McDonald, Ltd. In turn, McDonald, Ltd. executed to the Bank a trust deed of the entire island, excepting the mineral rights which had in the meantime become of considerable value as the result of discovery of gas in 1935. Weyl continued to farm other property located elsewhere in Oregon and Utah.

Six months later—on December 21, 1946—the mineral rights in the entire island were sold to a subsidiary of Standard Oil Co., which ever since 1935 had been the lessee of the mineral rights under separate leases executed by the two companies.

At the time of this sale—as the result of the transactions above set forth—each of the two companies had become the owner of the mineral rights under the opposite portion of the island.

The conveyance to the Standard Oil subsidiary—Pacific Oil Co.—of the rights in McDonald Tract was made by Weyl direct to Pacific Oil.

But McDonald, Ltd., did not make a direct transfer to Pacific of the rights in Henning Tract. The reason for not pursuing that course was that it would have subjected McDonald, Ltd. to a penalty under the provisions of the trust deed which McDonald, Ltd. had executed to the Bank. To avoid this penalty McDonald, Ltd. declared a dividend in kind of the rights in Henning Tract and conveyed them to its sole stockholder, Weyl-Zuckerman & Company. Thereupon Weyl made the conveyance to Pacific Oil.

The Tax Court's decision—in the form of a conclusion drawn from the evidence—is that the plan was hatched in June, 1946, at the time when Weyl transferred Henning Tract to McDonald, Ltd.; that at that time Weyl had the intention to reacquire the mineral rights in Henning Tract at a stepped-up cost basis and thereupon sell them to the Oil Company; that the mineral rights must be deemed to have been retained by Weyl; and that insofar as its deed to McDonald Island Farms, Ltd. of Henning Tract in its entirety effected a transfer of the mineral rights in the land, the deed must be disregarded as sham.

2. Statement of petitioner's contentions and specification of errors.

The petitioner contends:

(1) That there is no evidence to justify the conclusion of the Tax Court;

(2) That when McDonald Island Farms, Ltd. was selected to farm the entire island and became the borrower from the Bank and the grantor in the deed of trust, the transfer of Henning Tract to McDonald Island Farms, Ltd. in its entirety was the natural course of business;

(3) That at that time—in June 1946—there was not even a likelihood of a sale of mineral rights to the Oil Company;

(4) That the so-called circumstantial evidence on which the Tax Court's decision is based consists of nothing more than an unwarranted theory that the business purpose of Weyl's conveyance to McDonald Island Farms, Ltd. of Henning Tract should have been accomplished by a transfer of the surface rights alone without the mineral rights;

(5) That to divorce the mineral rights from the surface rights would have been an unusual proceeding;

(6) That the failure to divorce them and the conveyance of Henning Tract in its entirety does not constitute circumstantial, or any evidence, authorizing the inference of a present intent to evade taxes by recapture of the mineral rights, nor does such an inference follow from the fact that six months later the mineral rights were returned to Weyl as a dividend in kind;

(7) That the only transaction which the Commissioner could have questioned was the dividend in kind by which McDonald Island Farms, Ltd. conveyed to Weyl the rights in Henning Tract;

(8) That any attack on the integrity of that dividend—if successful—would authorize the Commissioner to tax McDonald, Ltd. on the theory that its conveyance must

be deemed to have been made direct to the Oil Company with a resultant capital gain;

(9) That the possibility that McDonald, Ltd. was subject to such a tax and that the Commissioner failed to levy a deficiency against that company does not justify the Commissioner in charging Weyl with a capital gain on a theory which has no basis in fact;

(10) That the Tax Court's conclusion in favor of the Commissioner's theory involves speculation and conjecture and is not supported by any evidence.

3. Statement of facts with appropriate reference to findings and evidence.

Henning Tract is farming property located on one portion of McDonald Island in the delta region of the San Joaquin River in San Joaquin County, California. The tract was acquired by petitioner prior to 1932. It had been formerly owned by members of the Zuckerman family by whom the petitioner, Weyl-Zuckerman & Co., had been formed. (findings, T. pp. 25-26.)

Contiguous to Henning Tract was another known as McDonald Tract owned by McDonald Island Farms, Ltd. The two comprised an island in the delta known as McDonald Island. A slough runs through the island and forms the dividing line between the two tracts. Both had been farmed extensively year after year under separate ownership. (findings T. pp. 25-26.)

In 1931, members of the Zuckerman family purchased one-half of the outstanding shares of McDonald, Ltd. at the same time Holly Sugar Corporation (sometimes hereinafter called Holly) purchased the remaining one-half

shares. Thereafter in 1934, the Zuckermans transferred their shares to Weyl-Zuckerman & Co. in consideration for shares of that company. (stip. par. 4; findings, T. pp. 25-26.)

In 1935 gas was discovered under the surface of the island. Both Henning and McDonald tracts were in the same gas field. On November 18, 1935, Weyl leased to Standard Oil Company the mineral rights in Henning Tract. McDonald, Ltd. also leased to Standard Oil Company the mineral rights in McDonald Tract. (Ex. 5, deed from Weyl to Pacific Oil Company containing recitals of leases; findings, T. pp. 25-26.)

In later years the surface and mineral rights in McDonald Tract were separated as the result of the insistence on the part of Holly that McDonald, Ltd. declare dividends to its two stockholders.

First, there was a dividend in kind declared August 11, 1943, by McDonald, Ltd. of a two thirds interest in the surface rights of McDonald Tract. Consequently, Holly received a one-third undivided interest and Weyl received an undivided one-third interest. McDonald, Ltd. retained the remaining one-third undivided interest. McDonald, Ltd. also continued to own the mineral rights in McDonald Tract. (stip. par. 5; findings, T. pp. 26-27.)

Eventually, on December 27, 1944, pursuant to an option theretofore given to Weyl, Holly sold its one-third undivided interest in the surface rights of McDonald Tract. The option was not exercised by Weyl, but by a partnership composed largely of stockholders of Weyl. Accordingly, the surface rights were conveyed to this partnership. (stip. par. 5, T. p. 23; findings, T. p. 27.)

On June 15, 1946, the partnership sold this interest to Weyl so that as of that date Weyl was the owner of an undivided two-thirds interest in the surface rights, but no formal conveyance was executed. The remaining one-third was still retained by McDonald, Ltd., the corporation which had originally owned the entire fee. (findings, T. p. 30.)

In the meantime, Holly had been urging a dividend of the mineral rights in McDonald Tract. This was at first rejected by the board of directors. Holly renewed its request and Weyl consented to the declaration of the dividend on condition that Holly give Weyl an option to buy its share of the dividend. On March 13, 1946, McDonald, Ltd. declared the dividend and Weyl and Holly each received an undivided one-half interest in the rights. At the same time, Holly gave Weyl an option to purchase Holly's one-half interest in the mineral rights of McDonald Tract. On June 5, 1946, the option was exercised and Weyl became the owner of all the mineral rights therein. (findings, T. p. 28.)

On March 13, 1946, Weyl also purchased from Holly the latter's one-half interest in the shares of stock of McDonald, Ltd. Thereupon Weyl became the owner of all of the outstanding stock of McDonald, Ltd. (findings, T. p. 28.)

All during this time, while these transactions were taking place involving the resultant separation of surface and mineral rights in McDonald Tract, there was no such division with respect to the adjoining part of the island. Henning Tract in its entirety—including, of course, both

surface and subsurface rights—was continuously in single ownership—the property of Weyl. (findings, T. p. 30.)

Weyl's acquisition of Holly's interest in McDonald, Ltd. required considerable financing. Weyl borrowed money from the Bank of America as a temporary expedient. (T. p. 138.) In order to place the loan on a long-term basis, it was necessary to give as security the entire island, including both Henning Tract and McDonald Tract. This presented two problems: First, one of the corporations must be selected as the owner and grantor to be named in the deed of trust; second, the extent of the security must be negotiated. For adequate business reasons, which will be discussed later, McDonald, Ltd. was chosen to act as the borrower. (findings, T. pp. 29-30.)

Accordingly, on June 27, 1946, Weyl executed several conveyances to McDonald, Ltd. One of these was a grant, bargain and sale deed of Henning Tract. Since this tract had never been segregated as to surface and subsurface rights, no such segregation was made in the conveyance. The deed was in the customary form which is normally adopted in business transactions and McDonald, Ltd. became—for the first time in its history—the owner of Henning Tract. (findings, T. p. 30.)

McDonald, Ltd. borrowed \$720,000 from the Bank of America. The proceeds of the loan were used to pay for the property acquired from Weyl (which, in turn, paid off its obligations to the Bank); to remove various encumbrances so as to provide a clear title; and to satisfy other items of indebtedness. (findings, T. pp. 28-29; T. pp. 137-139.)

The leases of mineral rights to Standard Oil Company provided for royalty payments. It was to the advantage of McDonald, Ltd. to preserve these royalties rather than to assign them to the Bank as part of the security for the loan. The Bank acquiesced. Consequently, the mineral rights in the island were excluded from the operation of the deed of trust. (findings, T. p. 29.)

As a part of the same transaction, McDonald, Ltd. agreed in writing with the Bank of America that annual payments of \$28,800 on account of principal of the loan would be made to the Bank and that, in addition thereto, there would be paid on account of principal a sum equivalent to the difference between \$28,800 and "35% of the net profits of the corporation for the prior fiscal year; net profits as here used shall mean profits before depreciation, but after provision for Income Taxes". (findings, T. pp. 29-30.)

The significance of this provision is that when an opportunity arose later to sell the mineral rights, a direct conveyance to the purchaser would have resulted in a profit, so that McDonald, Ltd. would have become obligated to pay \$50,000 to the Bank on account of principal of the indebtedness. It was to avoid this penalty that the expedient of a dividend from the subsidiary to the parent was adopted.

The gas field in which both the Henning Tract and the McDonald Tract were located also included two other properties in the vicinity owned, respectively, by Mayberry and Tilden. As gas was withdrawn from the field, Standard Oil Company determined the percentage to be allot-

ted to each of the four properties and paid royalties on that basis. (findings, T. p. 31.)

For several years prior to 1946 there had been a dispute between the Standard Oil Company and Weyl as to the allotment. Another point in controversy between Weyl and Standard was based on the drilling of a well known as Mayberry No. 2 on the Mayberry property. Weyl's contention was that by reason of the location of this well, it was Standard's obligation under the lease with McDonald, Ltd. to drill an offset well on McDonald Tract. (id.)

In November, 1945, George Schroeder, acting for Standard Oil Company, offered \$500,000 for the mineral rights in the island. This was rejected. (findings, T. p. 27.)

In July, 1946—about a month after Weyl obtained complete control of McDonald, Ltd. and its property—Weyl offered to sell the gas rights to Standard Oil Company for \$875,000, but it was indicated that Weyl would be willing to reduce the price to \$820,000. The offer was rejected. (findings, T. p. 31.)

In the interval between these two offers the subject of sale had not been mentioned. Likewise, the subject was dropped after the rejection of Weyl's offer. (See testimony of Schroeder, the Commissioner's witness; T. pp. 151-153; 157.)

In the latter part of 1946 litigation appeared imminent. (findings, T. p. 31.) On December 12, 1946, there was a meeting between John Zuckerman and Schroeder. This led to an agreement on a figure of \$650,000 as the price of the gas rights, subject to adjustment on account of the royalties paid during 1946, during the interval since Schroe-

der's first offer of \$500,000, resulting in a net figure of \$609,514.46. Shortly thereafter the sale was consummated to Pacific Oil Co., a subsidiary of Standard Oil Co., as the buyer. (testimony of Schroeder, T. p. 158.)

When the negotiations began on December 12, 1946, McDonald, Ltd. was—as appears above—the owner of Henning Tract, including the surface and mineral rights therein. By reason of the agreement collateral to the deed of trust, as above set forth, if McDonald, Ltd. had conveyed the gas rights in Henning Tract direct to the buyer, McDonald would have received a net profit and would have been compelled to make a payment to the Bank of America in the amount of approximately \$50,000 on account of the principal of the loan of \$720,000, in addition to the annual amortization requirements. McDonald, Ltd. needed all available cash and, therefore, on December 21, 1946, in order to avoid the penalty and in preparation for the consummation of the sale, McDonald, Ltd. declared a dividend of the mineral rights in Henning Tract to Weyl as its sole stockholder. Thereupon, a deed of mineral rights bearing date December 21, 1946, was executed by McDonald, Ltd. to Weyl and was recorded January 10, 1947. Consequently, Weyl was the owner of the mineral rights in both Henning Tract and McDonald Tract and was in a position to make the conveyance to Pacific. (Ex. 9; findings T. p. 32.)

The conveyance of the mineral rights in Henning Tract by McDonald, Ltd. to Weyl pursuant to said dividend was made—as the law required (Section 115(j) Internal Revenue Code)—on the basis of the fair market value, which was ascertained to be \$230,000. This value represented the

proportionate share of the Henning Tract rights with respect to the purchase price to be paid by Pacific Oil Co. for the rights in the entire island, comprising both McDonald and Henning Tracts.

After deducting "the dividends received credit" of 85%, the balance was taxed at the normal and surtax rates amounting to \$13,110. This, together with taxes on other income, was paid by Weyl in 1947.

The portion of the sales price received by Weyl from Pacific Oil Co. for the gas rights in Henning Tract was the same amount as that used for determining the income received by Weyl as the result of the dividend. Consequently, there was no capital gain or loss in the sale of the Henning Tract gas rights to Pacific Oil Co.

Returning now to the time when the decision was reached that McDonald, Ltd. should be the borrower from the Bank and the grantor in the deed of trust, there were various business reasons leading to that conclusion, to wit:

Farming Reasons.

It was advisable to have the farming operations concentrated under single management and ownership. The two tracts—McDonald and Henning—were being farmed side by side and were separated only by a slough. Both were suitable for growing the same kinds of crops. It was far more economical to operate them as a single unit. The crop yielding the highest revenue was potatoes. However, intelligent farming requires the rotation of crops in successive seasons and planting those which enrich the soil, even though they are not lucrative. When the two tracts

were separately farmed, it was necessary to devote some portion of each to raising potatoes and also to raising soil-building crops. On the other hand, under single operation the land best suited to potatoes could be used for that purpose whether it was located on one side of the slough or the other. (T. pp. 54-57.)

Operating Reasons.

In mechanized farming the use of much equipment is essential. It is also necessary to maintain an extensive machine shop. By consolidating the farming operations in a single company, one set of equipment sufficed instead of two, and likewise one machine shop instead of two. It eliminated the necessity of transferring equipment and men from one side of the island to the other, together with the accounting procedure resulting from such exchange. Likewise, it eliminated the necessity of maintaining two complete sets of books. All this made for economy in operation. (T. p. 55.)

Financial Reasons.

In order to procure the loan from the Bank it was necessary to hypothecate both tracts of land free of encumbrances. (T. pp. 49-50.)

There were outstanding against Henning Tract reclamation bonds amounting to \$146,000, in addition to obligations evidenced by notes aggregating \$161,000. (T. p. 138.) Extensive financing could most readily be accomplished by consolidating the title in one company which, in turn, would execute a blanket deed of trust. (T. p. 58.)

Business advantages of selecting McDonald, Ltd. as the borrower.

McDonald, Ltd. had built up an advantageous excess profits base which might be of value in determining a fair rate of return on investment for tax purposes. (T. p. 65.)

McDonald, Ltd. had a favorable history with respect to potato acreage which entitled the company to a substantial allotment in the program of price support adopted by the Federal Government. (T. pp. 65-66.)

McDonald, Ltd. had a good credit rating due to the fact that it had been able to retire its bonded indebtedness and promptly meet its current obligations. On the other hand, Weyl had been in financial difficulty from time to time. (T. p. 66.)

Reasons with respect to relations with Standard Oil Company.

By reason of a running controversy with Standard Oil Company as to its obligations with respect to drilling offset wells (oral stipulation T. pp. 86-87; pp. 66-67), it was advisable to keep separate the ownership of the mineral rights in the two tracts. If a new well should be drilled on one side of the island, Standard would be obligated to drill an offset well on the other side. But if all the mineral rights in the entire island came under single ownership, this might have the effect of relieving Standard of this obligation. (T. pp. 66-67.)

The foregoing considerations were in the minds of the executives of the two companies as the basis for the decision to have McDonald, Ltd. borrow the money from the Bank of America and execute the deed of trust on both properties. To accomplish this it was necessary to convey Henning Tract to McDonald, Ltd. (T. p. 53.)

Henning Tract had never in the past been divided horizontally. Such division which had happened in the case of McDonald Tract was the result of the unusual circumstances involved in joint ownership of McDonald, Ltd. shares of stock by Holly and Weyl.

The preliminary steps leading up to the hypothecation of the land as security for the bank loan were handled on their own merits and without any thought of a sale of the mineral rights. Accordingly, it is petitioner's contention that neither the evidence nor the findings of fact made by the Tax Court authorize the inference that the transaction was sham and undertaken for the purpose of avoiding taxes.

4. The facts are undisputed. The issue concerns the inference to be drawn from the facts.

The Tax Court did not find as a fact that at the time Weyl conveyed Henning Tract to McDonald, Ltd., Weyl intended to re-acquire the mineral rights at a later date. The Tax Court reached this conclusion as an inference which it drew from undisputed facts.

Hence, we have no problem involving the power of an appellate court to review and reject a finding of fact.

The findings of the Tax Court set forth the history of Weyl's acquisition of McDonald, Ltd.: first, the joint venture with Holly Sugar Corporation, and eventually the purchase of Holly's interest.

The findings set forth the transactions by which the acquisition of Holly's interest was financed: the consolidation of the farming operations on McDonald Island in the hands of McDonald, Ltd. and the loan of \$720,000 from

the Bank of America secured by a deed of trust of the island, excepting the mineral rights.

The findings neither affirm nor deny the reasons for the selection of McDonald, Ltd. as the operating company. The testimony on this subject was not contradicted; there was no element of inconsistency in the testimony; on the contrary, it was in harmony with the facts found by the Tax Court to be true and with all other details of the transaction and the opinion concedes that "it may be true that the farming operations on McDonald Island could be more efficiently conducted if all the surface rights were in a single ownership." (T. p. 37.) But—the opinion proceeds—"the ownership of the mineral rights is completely immaterial in this connection." (id.)

The conclusive aspect of the matter is that Henning Tract was transferred to McDonald, Ltd. as part of a business transaction which was essential to provide the funds for buying out Holly's share. The Tax Court does not even intimate that there was anything sham about the conveyance insofar as it effected the transfer of the surface rights in Henning Tract. It is only the inclusion in the conveyance of the mineral rights in Henning Tract that the Tax Court has found subject to criticism.

The findings of the Tax Court also set forth the three isolated conversations on the subject of sale of the rights to Standard Oil Company. The first was in November, 1945, when Schroeder—the Standard Oil representative—proposed the unacceptable figure of \$500,000; the second in July, 1946, when Zuckerman offered to sell for \$820,000—an offer which was likewise rejected; and the third in December, 1946, when the parties reached an area of

accord. The findings demonstrate that the intervals were arid of discussion; that there was no continuous dickering; that on the contrary, the parties were so far apart as to price as to indicate the impossibility of a sale and that instead of an amicable outcome the prospect was one of litigation as to the proper allocation of the gas being withdrawn from the field.

Hence, the issue to be decided here is whether these undisputed facts authorize the inference that when Weyl conveyed Henning Tract it intended to obtain the return of the mineral rights by way of dividend and to sell them to the Standard Oil Co.

The opinion of the Tax Court states that "the question is largely one of fact". (T. p. 35.) If that were correct, we should expect a finding of fact. The absence of any such finding demonstrates that the decision of the Tax Court depends on inference, which, we respectfully contend, is not warranted by the evidence.

5. **The only so-called "circumstantial evidence" on which the Tax Court's decision rests is the fact that conveyance of the mineral rights in Henning Tract was not necessary to consummate the program of financing. This fact cannot authorize the inference that the transaction was sham.**

The issue is one of intent. It is stated in the opinion of the Tax Court as follows:

If petitioner intended from the beginning, through those who controlled its affairs, to transfer the entire Henning Tract to the subsidiary with the expectation of a re-transfer of the mineral rights, it is hardly likely that such intention would be admitted. The intention, if it did exist, would ordinarily have to be established by circumstantial evidence. (T. p. 35.)

And the Tax Court concludes:

. . . that the round-trip of the mineral rights was contemplated from the start and was lacking on bona fides. (T. p. 36.)

The Tax Court concedes (T. p. 35) that there is no direct evidence of an intent to have the mineral rights in Henning Tract make what is described as a "round-trip". But—the Court declares—there is "circumstantial evidence" of this intent.

In discussing the principles applicable to circumstantial evidence, the Court of Appeals in *Adair v. Reorganization Inv. Co.*, 125 F.2d 901 (C.C.A. 8th), said (p. 905):

If the proven facts give equal support to each of two inconsistent inferences then judgment must go against the party upon whom rests the necessity of sustaining one of these inferences. The essential inference cannot be left to conjecture and speculation. (Citations.)

In *Rider v. Griffith*, 154 F.2d 193 (C.C.P.A.), it was held (p. 197):

Proof of the fact inferred from circumstantial evidence cannot rest upon conjecture and speculation . . . We said in *Fersing v. Fast*, 121 F.2d 531, 534 . . . "suspicions cannot supply the requirements of the law."

In *Pevely Dairy Co. v. United States*, 178 F.2d 363 (C.C.A. 8th), the court, in reversing a conviction for conspiracy on the ground that there was insufficient evidence, quoted with approval from *Wesson v. United States*, 172 F.2d 931 (C.C.A. 8th), the following language (p. 370):

To sustain a finding of fact the circumstances proven must lead to the conclusion with reasonable certainty and must be of such probative force as to create the basis for a legal inference and not mere suspicion. Circumstantial evidence, even in a civil case, is not sufficient to establish a conclusion where the circumstances are merely consistent with such conclusion or where they give equal support to inconsistent conclusions. (Citations.)

Record evidence—definite and unimpeachable—provided legitimate reasons for the various transactions involved. But the Tax Court has drawn the inference that it was all make-believe; that every step in the proceeding culminating in the sale to Standard Oil was planned from the very beginning with one single accomplishment in mind—to swindle the government out of taxes. The testimony of witnesses for the petitioner provided the background for the introduction of the records. It was not incumbent on petitioner to have them protest their innocence of fraud. On the other hand, the Commissioner had ample opportunity on cross-examination to probe their intent. But not a single question was propounded in behalf of the Commissioner to elicit such evidence.

What circumstantial evidence is there of an intent “at the beginning” to initiate a sham transaction and to reacquire the mineral rights in Henning Tract?

The gist of the Tax Court’s decision is that there was no business necessity for the inclusion in the conveyance of the mineral rights in Henning Tract; in other words, that when Weyl transferred Henning Tract to McDonald, Ltd., the mineral rights should have been excepted.

This theory—we respectfully submit—is not sound in itself; and furthermore, even if it were acceptable, it would not suffice to justify the conclusion that a “round-trip” was intended.

The opinion of the Tax Court concedes that

... it may be true that the farming operations on McDonald Island could be more efficiently conducted if all the surface rights were in a single ownership

...

(T. p. 37.)

The Tax Court also recognizes:

... that petitioner merely employed a standard form of deed on June 27, 1946, when it transferred Henning Tract in its entirety to the subsidiary.

(T. p. 39.)

Hence, the Tax Court does not question the fact that there was—as the evidence proves beyond dispute—a sound business purpose for the transfer of Henning Tract as far as the title to the land was concerned. The Tax Court does not question the fact that a grant bargain and sale deed is the usual means of transferring title.

The reasons offered by the Tax Court¹ for rejecting the bona fides of Weyl's deed are:

(1) That the mineral rights in Henning Tract were not necessary to the business of McDonald, Ltd., the grantee, nor to the accomplishment of the prospective financing (T. pp. 37; 39-40); and

¹The opinion of the Tax Court is addressed to the contents of the protest. Since the protest purports to state the case in brief general terms, the subject should be considered in the light of the evidence adduced at the hearing.

(2) That the same course was not followed with respect to the contemporaneous conveyance by Weyl to McDonald, Ltd. of its interest in the other side of the island—McDonald Tract;

The answer to the first ground is that in conveying Henning Tract to its subsidiary, there was no duty on the part of Weyl to consider the extent of the title which the subsidiary would need in order to consummate the loan from the Bank. There had never been a separation of surface and mineral rights in Henning Tract. There was no reason why it should have occurred to anyone to incorporate into the deed a provision carving out the mineral rights. There was no reason why the subject should have been given any consideration. There is no evidence—circumstantial or otherwise—that the subject entered the minds of those who handled the transaction.²

Furthermore, if the idea of separation had arisen, it would have been inadvisable from every common-sense business standpoint. Troublesome accounting problems would have been created. The cost of Henning Tract to Weyl was \$338,375. (findings, T. p. 30.) It would have been necessary to allocate this partly to surface and partly to mineral rights. On what basis should such an allocation be made? Why should it be made at all? Why should the idea have entered the heads of those who on behalf of Weyl decided that McDonald, Ltd. should own the prop-

²The Tax Court says: "It was therefore misleading to suggest that the proposed bank loan was a motivating factor in the transfer of the mineral rights to the subsidiary" (T. p. 38). No such suggestion was made either at the trial or in the protest. The bank loan was the motivating factor of the transfer of Henning Tract. The conveyance took the customary form.

erty and execute the deed of trust? Certainly, there was no duty on their part to complicate the transaction further. There was every sound business reason why the conveyance should be made exactly as it was made.

If the surface and mineral rights in Henning Tract had been divorced, and if the transaction should later have come under review by the taxing agencies, the Commissioner would have been the first to question the propriety of such an unusual transaction.

The fact that the deed of Henning Tract was in the usual and customary form suffices to satisfy the requirement of a business purpose as to all aspects of the deed.

Merely because it was intended to exclude the mineral rights from the deed of trust to be executed by McDonald, Ltd. to the bank does not detract from the business purpose of the deed.

Merely because the planned financing could have been accomplished by a deed covering the surface rights and excluding the mineral rights provides no reason for questioning the business purpose.

The only possible ground on which the business purpose of the deed—as to the mineral rights—can be repudiated is that on June 27, 1946, there was a present and existing plan—or at least a definite prospect—of a sale of the rights and an intention—on Weyl's part—to take back the rights when the time for a sale arrived.

There is no evidence that McDonald, Ltd. was to hold the rights only temporarily; nor that a tax-avoidance plot was hatched when the deed was executed.

There is no evidence that Weyl had any reason to believe that a sale to Standard Oil Company would be consummated.

If in November, 1945, or at any time prior to the meeting on December 12, 1946, Standard entertained any idea of paying a reasonable price for the rights, it was effectively withheld from the Weyl-McDonald, Ltd. interests. The reason for the meeting on December 12th was not to discuss a possible sale but to make one last effort to secure an equitable adjustment among the landowners in the field so as to avoid impending litigation.

Thus, there is no evidence that the idea of a prospective sale played any part in the calculations of Weyl in connection with the transfer of Henning Tract on June 27, 1946.

Surely, there was no duty on the part of Weyl's executives to look forward and consider the transaction in the light of a sale—then most unlikely—and to realize that by means of a conveyance to McDonald, Ltd. a program could be initiated which would—in the event of a sale—relieve Weyl from a capital gains tax and impose such a tax on McDonald, Ltd.

Now let us apply the test of circumstantial evidence. For this purpose we shall assume that the failure to exclude the rights could be consistent with a present intent to evade taxes by means of subsequent return of the rights and a sale thereof to Standard Oil.

But that does not meet the test. The inclusion of the rights is also explainable on the theory that in the ordinary course of business deeds take the form adopted in this instance. Hence, there are two inconsistent infer-

ences that may be drawn from the proven fact. It follows under the authorities cited above that the inference of intent to evade taxes cannot prevail. Furthermore, of the two explanations the one consistent with normal business practice is much more logical and reasonable than the far-fetched inference adopted by the Tax Court.

Hence, there is no basis for attacking the good faith of the deed because the mineral rights were not excluded.

The second ground advanced by the Tax Court involves a consideration of the history of the McDonald Tract and its former owner, McDonald Island Farms, Ltd. Holly Sugar Corporation had purchased half of the capital stock of McDonald, Ltd. Weyl had bought the other half. Holly insisted on dividends in kind. Weyl yielded under protest. First, two-thirds of the surface rights in McDonald Tract were distributed—one-third to each shareholder. Later, the mineral rights in McDonald Tract were distributed in equal shares. Zuckerman Potato Co., a partnership, bought Holly's one-third of the surface rights. Weyl bought Holly's one-half of the mineral rights.

Hence, when the time arrived to vest McDonald, Ltd. with the security to be hypothecated to the Bank, the various muniments of title were as follows:

A deed dated December 27, 1944, from Holly to Zuckerman Potato Co. of a one-third interest in the surface rights of McDonald Tract which still stood in the name of the partnership, notwithstanding that it had sold the interest to Weyl;

A deed dated August 11, 1943, from McDonald, Ltd. to Weyl of a one-third interest in the surface rights;

(The remaining one-third interest was still owned by McDonald, Ltd.)

A deed dated March 13, 1946, from McDonald, Ltd. to Weyl of a one-half interest in the mineral rights in McDonald Tract;

A deed dated June 5, 1946, from Holly to Weyl of a one-half interest in the mineral rights in McDonald Tract.

Thus, ever since the initiation of the program of dividends, the surface and mineral rights in McDonald Tract had been separated. Consequently, in vesting McDonald, Ltd. with the necessary security, the natural and reasonable course involved two conveyances only, viz.: one from Zuckerman Potato Co. of the one-third interest in the surface rights standing in its name, and one from Weyl of a one-third interest. The result of these two deeds was to vest the ownership of all the surface rights in McDonald, Ltd.

Thus, the course pursued with respect to McDonald Tract cannot furnish any criterion as to that with respect to Henning Tract. On the contrary, the same adherence to normal business routine resulted in the adoption of different forms of conveyance.

If any inference is to be drawn from the fact that Weyl did not transfer to McDonald, Ltd. the mineral rights in McDonald Tract, it is favorable to the good faith of the transaction. If Weyl envisioned the program of tax evasion of which it has been convicted by the Tax Court, it would have conveyed these rights so as to step-up their cost basis as well as those in Henning Tract. Another profitable course would have been to retain Hen-

ning Tract in its entirety and to revest McDonald, Ltd. with the title to McDonald Tract in its entirety. Then when the time arrived for the sale to Standard Oil, the McDonald Tract mineral rights could have been conveyed to Weyl as a dividend in kind. These were more valuable than those in Henning Tract. Hence, greater tax savings could in this manner have been accomplished.

It follows that there is no logical basis for the Tax Court's effort to use the method followed as to McDonald Tract for the purpose of impugning the good faith of the deed of Henning Tract.

We come now to the proposition that even if we were to concede the propriety of the Tax Court's criticism of Weyl's failure to reserve the mineral rights in McDonald Tract, this would not suffice as circumstantial evidence or otherwise to justify the conclusion that "when petitioner transferred the Henning Tract to the subsidiary it intended to recapture the mineral rights". (opinion, T. p. 39.)

6. **Even if normal business practice would have dictated a retention by Weyl of the mineral rights in Henning Tract, its failure to do so does not justify the inference that Weyl had a present intent to re-acquire those rights by means of a dividend so as to step-up the cost basis upon a sale of the rights.**

For the sake of argument, let us go along with the view of the Tax Court that the inclusion of the mineral rights in the conveyance of Henning Tract "had no business purpose" (opinion, T. p. 38) because it was unnecessary to the consummation of the bank loan.

But even that assumption—an unwarranted one—does not authorize the conclusion that there was in the mind

of Weyl's executives a present and existing intent to evade taxes by taking back the mineral rights in Henning Tract and selling them to Standard Oil.

To be sure, the case would be different if in June, 1946, Standard had made an acceptable offer for the rights and in preparation for the sale Weyl had conveyed Henning Tract to McDonald, Ltd. and then McDonald, Ltd. had promptly returned the rights to Weyl in the form of a dividend.

In that event, the case at bar would be comparable in some respects to *C. I. R. v. Transport Trading & Terminal Corporation*, 176 F.2d (C.A.2d) 570, hereafter to be analyzed.

But here there was not the slightest suggestion that at the time the financing problems were solved Standard Oil was willing to pay an acceptable price. The only offer—in November, 1945—was \$500,000. The evidence demonstrates that no one could reasonably have expected that a sale would be made. On the contrary, every indication pointed to the hopelessness of a deal. How far apart the parties were at that time is shown by the fact that the eventual price was thirty percent higher. In June 1946 the prospect was not one of sale but of controversy as to the ratable share of Henning Tract and McDonald Tract in the production of the gas field. And from that point on the situation deteriorated until in December, 1946, a lawsuit appeared imminent.³

³In its findings (T. p. 27) the Tax Court states that "There appeared to be two possible solutions" of the controversy: suit or sale. The Court overlooks the possibility of avoiding litigation by settlement of the dispute. This was never fully explored by the disputants because the sale made it unnecessary to do so.

Hence, there is no basis for the Tax Court's conclusion that the June 1946 transaction was a setting of the stage for a dividend in kind by McDonald, Ltd. to be followed by a sale of the rights to Standard Oil Co.

The Tax Court's conclusion of tax evasion cannot find any support in the finding that "Standard's offer to purchase the gas rights for \$500,000 in November of 1945 was an effort to solve the problem (the differences between Standard and Weyl) in that manner". It makes no difference why Standard was willing to buy, rather than pay royalties. The significant fact is that as of June 1946 Standard's conception as to the value of the rights was so low as to demonstrate the utter impossibility of a sale.

The Tax Court states the position of the Commissioner—which the decision approves—as follows:

The Commissioner argues that the transfer of the mineral rights to the subsidiary was not bona fide, that no business purpose was served or intended by such transfer, that the possible sale to Standard Oil was contemplated from the beginning, and that the round-trip of these rights from parent to subsidiary and back to parent again was engineered for the purpose of attempting to obtain a stepped-up basis.

(T. pp. 34-35.)

The answer is twofold: first, in June 1946 there was no "possible sale"; and second, even if Weyl had in mind that at some point of time in the indefinite future the parties might agree on a price, this was too nebulous

to provide a basis for convicting Weyl of a fraudulent scheme to avoid taxation.

What the evidence shows—and all that it shows—is that Weyl was interested in selling the rights to Standard; and that Schroeder's offer in November 1945 of \$500,000 was so low as to indicate the impossibility of a sale. That was the situation in June 1946 at the time of the conveyance of Henning Tract to McDonald, Ltd.

In July 1946 Weyl offered to sell for \$820,000. This was rejected. The Tax Court attaches "great importance" to this offer. (footnote 2, T. p. 39.) The Tax Court says:

The affirmative step thus taken by petitioner within so short a period is highly persuasive that the transfer was made with a view towards attempting to bring about a sale thereafter.

(id.)

The answer is that there is no logical connection between the offer to sell and the prior conveyance. The making of the offer cannot provide any basis for determining the purpose of the prior conveyance. All that the offer shows is a willingness to sell. To be sure, if a deal had been arranged in June 1946, or if Weyl and Standard were in an area of agreement as to price, it might be inferred that the ensuing transactions were part of a scheme to evade taxes. But a willingness or even a desire to sell is not enough to convert a legitimate and essential loan transaction into a tax fraud.⁴

⁴The footnote above mentioned (T. p. 39) charges mendacity in the protest because it referred to the approach by Pacific Oil Com-

The foregoing analysis of the evidence should demonstrate that there is nothing in the record on which to base an inference of a tax fraud and that petitioner has been unjustly convicted of this charge.

pany with an offer to buy. The Tax Court disputes this, saying that "it was petitioner's president who approached Standard."

But the Tax Court has misinterpreted the protest—possibly not without reason because it was not a model of clarity and apparently the product of an unskilled craftsman.

The conversation to which the protest referred was not the one initiated by Weyl's president in July 1946. The Pacific Oil Co. was not in the picture at that time. It first appeared in December 1946 when a reopening of negotiations led to an agreement as to price. That was the "approach" to which the protest sought to refer. According to John Zuckerman's testimony, the overture on that occasion came from Schroeder (T. p. 89). At all events, there is no basis for charging the petitioner with false representation.

The Tax Court also condemns the protest because "the initiative at this time did not come from Standard or its subsidiary, Pacific Oil Co." (footnote, T. p. 39). The catch inheres in the words "at this time". It was established beyond question that the initiative had originally come from Standard in November 1945 (findings, T. p. 29).

The "approach" by "petitioner's president" to which the Tax Court refers came later—in July 1946. As to the conversation in December, 1946, the witnesses are not in accord as to which of the two first mentioned a sale. As we have seen, John Zuckerman says it was Schroeder. Schroeder's version differs. (T. p. 157.) But the difference is immaterial. The Tax Court's charge of falsity is not based on this incident; and furthermore, the petitioner was entitled to present in its protest the recollection of its officers. The description of Pacific Oil Co. as a third party is not open to criticism. The other two parties were Weyl and McDonald, Ltd.

The author of the protest could have had no incentive to attempt to deceive the Commissioner into the belief that the offer in December 1946 was the first occasion on which a sale had been mentioned. The Commissioner would not be so naive as to accept the contents of the protest without investigation. And when the case came to trial the petitioner's witnesses were the first to provide testimony as to the previous conversations.

We respectfully submit that the Tax Court's characterization of the protest is unjustified. But certainly it would be unjust to permit this circumstance to be used as a means of developing prejudice against the petitioner or of indicating a disposition on its part to commit fraud.

There is still an additional fallacy in the Tax Court's theory. To make a case of tax evasion, the findings must justify the inference that in June 1946 Weyl had in mind and planned the entire transaction from beginning to end, including not only the sale of the rights to Standard but also the dividend in kind by McDonald, Ltd. as the step preliminary to the sale. There is nothing in the evidence or the findings to authorize such an inference. All that the evidence shows is that when the time arrived for conveyance to Standard's nominee, McDonald, Ltd. was confronted by the prospect of making a payment of \$50,000 on the principal of the bank loan, if the transfer of the Henning Tract rights should be made direct to the buyer. The whole enterprise was on thin ice; this \$50,000 could not be spared. The penalty could be avoided by means of a dividend in kind. There is not a scintilla of evidence that the idea of the dividend was considered or contemplated prior to this occasion. The decision of the Tax Court in this respect represents mere speculation.

Next we come to the implication in the Tax Court's findings that Standard had prepared separate deeds to be executed by Weyl and McDonald, Ltd., but at the direction of Weyl's counsel a different route was pursued. (findings, T. p. 32.)

If there was evidence to that effect, it would be immaterial. If there was any deviation from Schroeder's idea as to the mechanics of passing title, it was the result of the interposition of the dividend in kind. Let us assume, for the sake of argument, that Schroeder was not aware that the dividend had been declared by McDonald,

Ltd. and that all the mineral rights on the island had been consolidated in Weyl. Let us assume that Schroeder expected separate deeds, but thereafter learned that a single conveyance from Weyl would suffice. This aspect of the matter cannot lend any support to the conclusion of the Tax Court that a tax evasion was planned in June 1946.

Furthermore, the Tax Court's finding involves a gratuitous assumption. There is no doubt that the Commissioner's counsel was permitted vigorously to cross-examine his own witness, Schroeder, in an effort to elicit testimony that separate deeds had been prepared by Standard's counsel. But time and again Schroeder testified that he had no recollection as to the state of the title (T. p. 170) nor as to any distinction between the two tracts. (T. p. 172.) For a third time he reiterated his lack of recollection. (T. p. 173.) All that he could remember was that a form was submitted to Weyl's counsel, that "we proceeded then to talk about putting certain modifications in the leases" (T. p. 173); that "the papers were a grant with certain reservations" (id.); and that Weyl's counsel "wanted to go a slightly different route, wanted to submit (his) own papers". (id.)

Obviously, it was a matter of indifference to Schroeder what the form of the conveyance was; all he wanted was title to the rights. (T. pp. 171, 173.) It would have been more in keeping with the rules of evidence to procure from Schroeder the documents which Standard's attorneys had prepared. The subject was not one which could be properly explored by oral testimony. But all efforts on the part of Weyl's counsel to urge this point

were summarily rejected by the learned trial judge who even went so far as to charge Weyl's attorney with "engaging in obstructive tactics". (p. 160.)⁵

Thus, neither the findings nor the evidence provide any indication as to the content of papers prepared by Standard. Hence, no significance should be attached to the Tax Court's finding as to a "different route"; the finding has no evidentiary support.

We conclude that there is no circumstantial evidence to support the Tax Court's inference that the conveyance of Henning Tract to McDonald, Ltd. in June 1946 was the first step in an existing program to evade taxes by a subsequent dividend in kind of the mineral rights and a sale to Standard Oil Co.

7. **Other aspects mentioned by the Tax Court provide no support for the inference that an intent to evade taxes by recapturing the rights was present from the beginning.**

The Tax Court made findings (T. pp. 30-31) as to the cost to Weyl of Henning Tract, the increase of its value on Weyl's books, the fact that when Henning Tract and the two-thirds undivided interest in the surface rights of McDonald Tract were sold by Weyl to its subsidiary the price fixed was the original cost which was less than the current fair market value.

The opinion of the Tax Court does not undertake to show how these facts can provide support for the con-

⁵When Weyl's attorney sought to defend his conduct, the learned trial judge stated that his remark had been magnified "far beyond its import" and that "there was no intention at all to reflect upon you." (T. p. 164.)

clusion that the transaction was sham from the beginning. The truth is that these facts have no relevancy to the issue and can make no contribution to the solution of the controversy.

At the time of acquisition of Henning Tract, it was entered on the books of Weyl at cost. As the years passed and the value of the dollar diminished, land values accordingly increased. To reflect this an increment was recorded on the books in 1913 of \$125 per acre and another in 1926 of \$50 an acre.

But when the time came for conveyance of Henning Tract to the subsidiary, there was no reason to fix a price in excess of cost. To have done so would have violated proper accounting practice which dictates that no profit or loss should be taken on conveyance of property by a parent to a subsidiary.

In "Advanced Accounting" by E. I. Fjeld and L. W. Sherritt (The Ronald Press Company, 1946), Chapter 9, page 213, it is said:

Unrealized Profit in Fixed Assets

If sales of any type of fixed assets are made by one company to any other company in a consolidation, any unrealized profit should be eliminated, as with inventories.

Fixed Assets Sold by Parent to a Subsidiary

If a parent company sells the assets to one of its subsidiaries, the unrealized profit will remain in the parent company's surplus. Since no minority is involved, the entire profit is unrealized and must be eliminated.

And in "Advanced Accounting" by Wilbert E. Karrenrock and Harry Simons (Southwestern Publishing Company, 1949), at page 253, it is said:

Intercompany Profit on Assets Other Than Merchandise

The practices that are followed in eliminating intercompany profits on inventories are equally applicable upon the intercompany sale of properties other than inventories.

The obvious reason for this rule is that if a profit were shown, an artificial result would ensue. First, the seller would show a capital gain; second, the value on the buyer's books would be increased so as to permit a higher rate of depreciation. Both of these consequences are unrealistic in the case of two affiliated corporations.

In this connection it should also be noted that for many years Schedule D (Form 1120), issued by the Internal Revenue Service, has contained with respect to capital gains and losses the following instructions:

State with respect to each item of property reported in Schedule D (1) and (2): (1) How property was acquired; (2) whether at time of sale or exchange (a) purchaser owned directly or indirectly more than 50 percent in value of your outstanding stock, (b) where purchaser was a corporation, more than 50 percent in value of its capital stock and 50 percent in value of your capital stock was owned directly or indirectly by or for the same individual or his family, and (c) where purchaser was a corporation, whether more than 50 percent in value of its capital stock was owned directly or indirectly by you.⁶

⁶The foregoing citations were presented in petitioner's brief in the Tax Court, but are not mentioned in the opinion.

The purpose of eliciting this information is to afford the Commissioner an opportunity to investigate transfers between the parent and a subsidiary.

If it were mandatory or even permissible for a parent company to sell an appreciated asset to its subsidiary at more than cost, then it would likewise be permissible to sell a depreciated asset at less than cost. This would enable the parent to take a loss which could prove advantageous for tax purposes. It is certain that the Treasury Department would be the first to challenge such a transaction.

Hence, if any implication is intended by the Tax Court that the price at which the assets were sold to the subsidiary is evidence of bad faith, such implication must be rejected. The transfer at cost was eminently proper. In the hands of McDonald, Ltd. the original cost base of Henning Tract was preserved. This fact cannot provide support for the inference of an intent on the part of Weyl to re-vest itself with the title to Henning Tract or the surface or mineral rights therein.

This brings us to the dividend in kind declared in December, 1946, by McDonald, Ltd. to the parent company. Assuming any doubt as to the genuine business purpose of the dividend, this would be the first transaction open to criticism. But—as we shall now demonstrate—it can provide no basis for challenging the good faith of the conveyance of Henning Tract in June, 1946.

8. The business purpose of the dividend in kind in December, 1946, was clearly established. However, even if the dividend were open to question, this would not supply a basis for the conclusion of the Tax Court that the intent to recapture the Henning Tract mineral rights existed in June when Henning Tract was conveyed to McDonald, Ltd.

In a previous section we have summarized the conditions which prevailed when the time arrived for conveyance of the rights to Pacific Oil Co. Henning Tract was owned by the subsidiary—McDonald, Ltd. A conveyance of the Henning Tract mineral rights direct to Pacific would have entailed the expenditure of \$50,000 of essential capital by way of payment on account of the principal indebtedness to the bank. This was established without conflict by documents in evidence and summarized in the findings. No question could be raised as to the integrity of this dilemma. The opinion of the Tax Court does not undertake to dispute it or even discuss it.

The Tax Court has ruled that the “intermediate steps were lacking in bona fides, and must be ignored”. (T. p. 40.) The dividend in kind was one of the intermediate steps. It was dictated by business necessity.

But even if the business purpose of the dividend could be disregarded, the only inference that could be drawn is that on this occasion the idea of tax savings first came into being. But even on this assumption the transaction could not be used as a ground to question the bona fides of the conveyance of Henning Tract made six months before on June 27, 1946.

If the dividend can be ignored as a tax evasion and the transfer in December, 1946, of the Henning Tract

rights must be deemed to have been made directly by McDonald, Ltd. to Pacific Oil Company, the result would be that McDonald, Ltd. would be subject to tax on capital gain.

This is what occurred in *C. I. R. v. Transport Trading & Terminal Corporation*, 176 F.2d 570 (C.A.2d). There American-Hawaiian SS Co. sold to its subsidiary, Transport Trading & Terminal Corporation, certain securities. The sale was made in 1937 and a capital loss of \$480,000 was reported by the parent company and allowed for tax purposes.

In 1940 by reason of the war in Europe the securities had again attained their previous value. A purchaser was available. But instead of making a direct sale, the subsidiary declared a dividend in kind to its parent company, which thereupon made the sale for nearly \$600,000.

There was no legitimate reason for the dividend. It was obviously an intermediate step adopted for the sole purpose of escaping taxation. The Commissioner so held and was affirmed by the Circuit Court.

But the tax was levied on the subsidiary—not the parent. Therefore, assuming that the case at bar could be controlled by the Transport decision, it would follow that McDonald, Ltd. sold the Henning Tract gas rights to Pacific Oil Company with the result that it earned a capital gain and was subject to a tax thereon. Obviously, there would be no basis for taxing Weyl-Zuckerman & Co.

The *Transport Trading Corporation* case is not authority for the decision of the Tax Court in the case at bar.

Aside from the factual difference resulting from the business necessity of the dividend by McDonald, Ltd.—if the *Transport* case possesses any relevancy, it demonstrates that the Commissioner has taxed the wrong company here. His error cannot be rectified by means of such speculative considerations as those adopted by the Tax Court.

9. **The production by Weyl of evidence of the circumstances of the conveyance eliminated from the case the presumption in favor of the Commissioner's action.**

The Tax Court quotes from the reply brief of petitioner the following statement:

In order successfully to attack the conveyance of Henning Tract as to mineral rights, the Commissioner must show that they were included with the intent to pull them back again into the petitioner for purposes of ultimate disposition.

(T. pp. 35-36.)

The Tax Court states that in making the foregoing comment "petitioner's counsel completely misconceives the burden of proof", and the Tax Court declares:

The burden is not upon the Commissioner. The burden is upon the petitioner to overcome the correctness of the Commissioner's determination.

(T. p. 36.)

But the Tax Court fails to give any consideration to the context in the reply brief or to the principle that the production by the taxpayer of evidence material to the transaction deprives the Commissioner of the benefit of the presumption.

That is the situation at bar. That, likewise, was the subject of the comment in the brief. The evidence established that Weyl had conveyed Henning Tract to McDonald, Ltd. as a part of a transaction having a definite business objective. The question then arising was whether there was a present intent to take back the mineral rights, so as to evade taxes. It was not the obligation of the taxpayer to prove the negative side of this issue. It was the Commissioner who contended that the evasion was planned from the beginning. He had the affirmative side of the issue. Hence, it was his duty to go forward with the evidence in order to supply proof of this essential factor. As the result of the production by Weyl of material evidence, the presumption in favor of the Commissioner which was available at the outset of the trial had disappeared from the case.

In *Hemphill Schools Inc. v. C. I. R.*, 137 F.2d 961 (C.C.A.9th), the question was whether the profits of the taxpayer were permitted to accumulate beyond the reasonable needs of its business. The Commissioner held that the profits were so accumulated. On that ground he imposed a surtax under section 102 of the Revenue Code.⁷

⁷102. There shall be levied, collected, and paid for each taxable year upon the adjusted net income of every corporation . . . if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting gains and profits to accumulate instead of being divided or distributed, a surtax . . . The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to avoid surtax.

The Board of Tax Appeals affirmed the determination of the deficiency. The decision of the Board is described in the opinion of the Court of Appeals as follows:

The Board's holding that petitioner was availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting gains and profits to accumulate instead of being divided or distributed appears to have been based on respondent's (Commissioner's) determination that petitioner's gains and profits were permitted to accumulate beyond the reasonable needs of its business.

(p. 963.)

But the taxpayer had produced evidence tending to show that its profits were not accumulated beyond the reasonable needs of the business. For this reason the Court of Appeals held that the presumption available to the Commissioner at the outset had disappeared and could not be weighed against the taxpayer's evidence. The Court of Appeals also held that the Board could not base its decision against the taxpayer on the ground that the taxpayer's evidence did not overcome the presumption. Accordingly, the Board's decision was reversed.

The Court of Appeals—after stating that the Board's ruling was based on the Commissioner's determination as to the unreasonable accumulation of profits—proceeded to hold:

Whether that determination was correct or incorrect was the principal, if not the sole, issue in the case. The burden of proving it incorrect rested on petitioner. Thus, if no evidence had been produced, the

Board would have had to accept the determination; for, until evidence was produced, the determination was presumed to be correct.

Evidence *was* produced. (Emphasis quoted.) Some of the evidence produced by petitioner tended to prove that its gains and profits were not permitted to accumulate beyond the reasonable needs of its business. Evidence having been so produced, *the presumption ceased*, and thenceforth the issue depended “wholly upon the evidence.” It thus became the duty of the Board to find from the evidence, and from it alone, whether petitioner’s gains and profits were permitted to accumulate beyond the reasonable needs of its business. No such finding was made. Instead, the Board, treated the presumption (*which no longer existed*) as if it were evidence, weighed it against petitioner’s evidence and concluded that petitioner’s evidence did not “overcome” it.

(pp. 963-964.)

The decision of the Court of Appeals was as follows:

Decision vacated and case remanded, with directions to (1) find from the evidence, and from it alone, whether petitioner’s gains and profits were permitted to accumulate beyond the reasonable needs of its business, such finding to be in addition to those heretofore made, and (2) thereupon enter such decision as may be proper.

(p. 964.)

In *Crude Oil Corporation of America v. C. I. R.*, 161 F.2d 809 (C.C.A.10th) the question was whether the taxpayer had in seasonable time mailed to the Collector its

election to declare a value for its capital stock under section 1202 of the Revenue Code.

The Commissioner ruled against the taxpayer. His determination was affirmed by the Tax Court.

Both sides had produced evidence at the trial in the Tax Court. It is set forth in the opinion of the Court of Appeals as follows:

The evidence in behalf of the petitioner established that the requisite return and election were enclosed in an envelope, properly addressed to the Collector's office at Oklahoma City, Oklahoma, with proper postage duly affixed thereto, and deposited in the United States mail at Tulsa, Oklahoma, in time to have been received by the Collector, in the ordinary course of mail, within the statutory filing period. The Commissioner introduced evidence as to the careful method of handling mail received by the Collector's office in Oklahoma City, from which it could have been inferred that the return and election were not received through the mail by the Collector's office.

(p. 810.)

The Tax Court failed to make any finding as to the filing of the return within the statutory period. "It merely held that the presumption of delivery was insufficient to overcome the presumption of correctness of the Commissioner's determination". (161 F.2d 810.) Hence, the Tax Court gave effect to the presumption notwithstanding the production of evidence by the taxpayer. This was held error and the cause was reversed. The Court of Appeals said:

We think the Tax Court fell into an error of law. The presumption of the correctness of the Commis-

sioner's finding is one of law. It is not an inference of fact. *It disappears when evidence, sufficient to sustain a contrary finding, has been introduced.*

* * * * *

Proof of due mailing is prima facie evidence of receipt.

It follows that the proof of regular mailing, in time to reach the Collector, in due course of mail, within the statutory filing period, was sufficient to support a finding that the return was timely filed; that the presumption of correctness attached to the Commissioner's finding vanished; and that the issue was for decision wholly on the evidence.

The cause is reversed with instructions to the Tax Court to determine the issue of fact and to give no weight to the presumption of correctness of the Commissioner's findings.

(pp. 810-811.)

These decisions control the case at bar. As the result of the production by petitioner of evidence as to the circumstances of the deed to McDonald, Ltd. the presumption of correctness of the Commissioner's determination was eliminated from the case. Thereupon it became necessary to determine the issue of intent and bad faith on the basis of the evidence. The Commissioner had the affirmative of the issue. In the absence of evidence of Weyl's intent to recapture the rights, the Commissioner could not prevail.

That was the point of the comment in petitioner's brief. The brief was not referring to the situation at the outset of the trial. It did refer to the situation at the conclusion of the evidence. The statement in the brief was correct. The Tax Court's criticism was not justified.

An interesting and pertinent discussion of the subject of burden of proof is found in 29 Taxes (The Tax Magazine) 221, by Mark Marcossou, C. P. A. He also brings up another point as to the effect of section 1112 of the Revenue Code which provides:

In any proceeding involving the issue whether the petitioner has been guilty of fraud with intent to evade tax, the burden of proof in respect of such issue shall be upon the Commissioner.

Marcossou comments as follows:

An interesting situation arises when the presumption in favor of the correctness of the Commissioner's determination runs head on into other legal presumptions . . . Where fraud is asserted, the burden of proof is on the Commissioner by express provision of the Code (Section 1112). This burden is only as to the issue of fraud, and the presumption of correctness still applies to the asserted tax on which the penalty is based.

In the case at bar, the Commissioner charged and the Tax Court found petitioner guilty of bad faith (T. pp. 24, 34, 36, 38, 40) which is the equivalent of fraud.

Hence, each presumption cancelled out the other and neither was available.

The Tax Court's erroneous concept as to the presumption is inherent in its approach to the issue and has undoubtedly contributed to its erroneous determination of the cause.

10. Conclusion.

We respectfully conclude that the decision of the Tax Court should be reversed.

Dated, December 5, 1955.

Respectfully submitted,

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